CHAPTER 3

Policies for Dynamic Labor Markets

Although the economy continued to grow in 2002, employment growth did not keep pace. From December 2001 through December 2002, nonfarm payroll employment fell by 181,000, a small figure compared with total employment of almost 131 million. During the same months the unemployment rate hovered between 5.5 and 6.0 percent. The lack of change in these statistics paints a picture of a labor market that is static and stagnant. But this picture is misleading: dynamic change remains the most fundamental characteristic of the U.S. labor market even today. The conventional misperception stems in part from the nature of most labor market statistics, which by necessity show the situation at only a single point in time, and which meld the often very different experiences of individual workers and households into a single aggregate measure.

A closer look suggests ripples—even crosscurrents—beneath the surface. The unemployment rate may have changed little in 2002, but the names and faces of the individual workers who are unemployed do change. What makes the labor market appear stagnant is that the official payroll employment and unemployment statistics that are the most visible indicators of the health of the labor market cannot capture its true dynamism. For example, in December 2002, 67 percent of unemployed workers reported being unemployed for 5 weeks or more; this point-in-time statistic may suggest that people who are unemployed this month will be unemployed next month. Yet a recent study of employment flows found that the majority of workers seeking work in any given month are not the same individuals who will seek work the following month. Similarly, over the same period in 2002 in which payroll employment scarcely grew, between 3.5 million and 5 million workers started new jobs each month, and roughly the same number quit or lost their jobs. This argues that dynamism, not stasis, is the essence of the U.S. labor market.

This dynamism and its implications for the design of economic policy are central themes of this chapter. Within these broad themes, the chapter discusses the rewards to skill and work generated by the U.S. labor market and how government policies can foster long-run job mobility by encouraging skill development and education. The labor market and the economy as a whole today face multiple challenges: in the short run, the challenge is to move past the recent downturn in the business cycle; in the long run, it is to address the risks associated with dynamism: technological change and growth inevitably lead to the destruction of some jobs and to the decline of certain industries. If the Nation can maintain the dynamism—the flexibility and mobility—of its labor markets, while providing all workers with meaningful insurance against unemployment and loss of income, both the cyclical and the structural economic challenges can be met without impairing those features of the labor market that foster long-run growth.

Economic downturns are a difficult time for many workers and their families, as growth in employment slows and unemployment and layoffs increase. The recent economic slowdown has been no exception. Flexible labor markets, however, can lessen the impact of a downturn on workers, and probably have done so since the recent contraction began. Although the unemployment rate did increase sharply during the contraction of 2001 and persisted at levels near 6.0 percent in 2002, unemployment remains low relative to the experience in previous recessions since World War II. Job creation and destruction continued despite the decline in nonfarm payroll employment.

Workers do not encounter economic difficulties only in recessions: even economic growth, or, more precisely, the structural change that accompanies that growth, makes some workers worse off. Advances in technology and the expansion of free trade provide benefits for consumers and for the vast majority of workers, yet these same changes do real harm to some workers in some areas of the economy. Workers displaced by technology or trade may remain unemployed for long periods or drop out of the labor force altogether. When they again find jobs, they are likely to earn less than at the jobs they lost.

Government has a role in assisting both those who suffer disproportionately during times of economic hardship and those who fail to benefit from, or are harmed by, economic progress. Among other things, government can provide retraining services and relocation assistance to those who would benefit from them, and it can reward reemployment, through appropriate provisions in the tax code, in social programs, and elsewhere, to encourage rapid reentry into the work force. In these and other ways, effectively designed government policies can help make labor markets work better. However, policies that fail to recognize the dynamics inherent in these markets can impair long-term economic mobility and the well-being of workers. Policies will support labor markets and help them work better if they recognize their dynamism and avoid undermining their ability to reward work and skill.

Social insurance, through unemployment benefits and similar programs, is an important mechanism by which government can assist those hurt or threatened by the forces of economic change. Yet policymakers face a tradeoff when seeking to provide social insurance. Such insurance is valuable in sustaining the well-being of workers and their families during periods of unemployment, but it can also distort both their incentives and their behavior, undermining what the U.S. labor market does best, namely, reward work and skill and match workers to jobs. In a static, unchanging world, policies that simply transfer public resources to those who are temporarily poor would not distort their behavior or lead to dependency on welfare. But in a world of continuous change in employment and unemployment, poorly designed policies can inadvertently inhibit upward mobility. Although this tradeoff cannot be entirely avoided, labor market policies are more effective when, recognizing the dynamism of these markets, they provide social insurance in a manner that least distorts workers' incentives to stay employed and to improve their employment situation.

The objective of social insurance is to guard individuals and households against sharp fluctuations in their standard of living that threaten their well-being. A standard assumption in economics is that most people would prefer their consumption to be certain and steady over their lifetime, rather than uncertain and variable. However, because employment and earnings vary in response to events outside their control, most people find that their incomes are not certain and steady. This creates a mismatch over time between their desired consumption and their actual ability to consume, which they seek to remedy by smoothing their incomes over their lives. They do this in a number of ways. One way is by saving part of their income when income is relatively high and by dissaving (that is, drawing down their savings, or borrowing) when it is relatively low. Another is by purchasing private insurance policies against unexpected and costly events, such as large health expenses, disability, or premature death. A third is by relying on informal private insurance mechanisms, such as support from family members and charities, when times are bad. Finally, the public safety net, of which social insurance is a vital part, acts as a backstop in case these private insurance mechanisms prove insufficient.

For most people, any spells of unemployment that occur during their working years are temporary. Public insurance programs would ideally therefore provide assistance only for a similarly limited duration. However, a well-known problem in insurance markets is that of moral hazard. Moral hazard arises when people who have insurance against a given risk have less of an incentive to take actions to minimize that risk than they would if they lacked insurance. For example, people who have generous health insurance may consume more medical services than they really need, because the additional services cost them little or nothing. Similarly, subsidized flood insurance may encourage building and rebuilding of homes in flood plains, because the insurer or the government, not the homeowner, pays when the house is destroyed in the next flood.

Moral hazard in social insurance can take the form of dependency on welfare. For example, for decades the Aid to Families with Dependent Children (AFDC) program provided income support for the poor but also generated substantial work disincentives that encouraged people to stay in poverty and out of the work force. The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA) transformed this system into one that acts more like insurance against temporary poverty and less like a permanent transfer program. PRWORA, the most important piece of welfare reform legislation in several decades, replaced AFDC with a new program, Temporary Assistance for Needy Families (TANF), and allowed States to implement innovative provisions in their welfare programs. (Many States had already implemented welfare reforms before 1996 by obtaining waivers from Federal welfare requirements.)

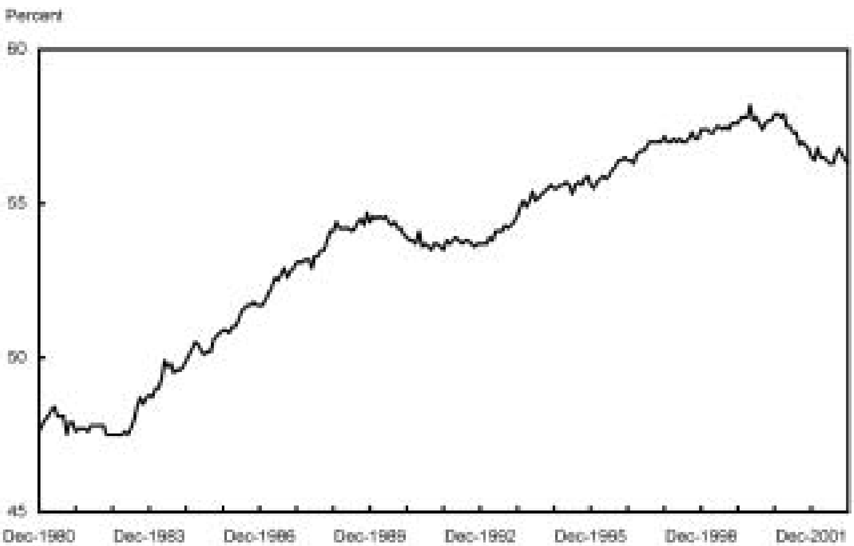
These changes, combined with time limits on welfare receipt and work requirements as a condition for benefits, quickly led to a large decline in caseloads. Research has found that these reforms led to increases in work, earnings, and income and a reduction in poverty. Other effects included an increase in the marriage rate and a reduction in the prevalence of single motherhood among women with little education (many of whom likely would have been welfare recipients had welfare reform not happened). In addition, States that placed a cap on welfare benefits, as opposed to increasing benefits if a mother had an additional child while on welfare, saw a reduction in out-of-wedlock childbirths. Welfare reform under PRWORA thus provides a striking example of how well-designed policies can meet the needs of those struggling in the face of labor market change while maintaining the incentives that underlie long-term economic growth.

The remainder of the chapter proceeds as follows. It first discusses the dynamics of employment and unemployment and provides examples of unemployment policies that are made with a dynamic labor market or with a static labor market in mind. Second, it discusses the dynamics of participation in welfare and other social assistance programs and contrasts those programs that are designed with an understanding of dynamic labor markets with those that are not. Finally, it discusses policies that support mobility and dynamism in labor markets by fostering investments in skill. For example, in January 2003 the President proposed the creation of Personal Reemployment Accounts. These would provide unemployed workers with up to $3,000 to use for training, child care, transportation, moving costs, or other expenses associated with finding a new job. Recipients who take a new job within 13 weeks would be allowed to keep the funds remaining in the account as a reemployment bonus. This would give unemployed workers an incentive to find work faster.

Employment Dynamics and Labor Market Policy

Whether from the perspective of the economy as a whole or from that of the individual worker, labor markets work best when they are fluid and flexible, that is, when workers and employers can change their mutually agreed-upon working arrangements as they see fit, to meet changing needs. Over the long term, the U.S. labor market has indeed been full of change. A vibrant economy created over 40 million new jobs between 1980 and 2002. Even though the population of the United States aged 16 and over grew by more than 46 million over the same period, a greater fraction of Americans are working today than in the past: civilian employment rose from 59 percent of the population aged 16 and over in December 1980 to 62 percent in December 2002. Women enjoyed a particularly large rise in their employment-to-population ratio over this period: for example, in December 1980, 48 percent of the female population were employed, but 56 percent had jobs in December 2002 (Chart 3-1). Meanwhile the proportion of the male population who were employed fell slightly, from 72 percent to 69 percent.

Chart 3-1 Employment-to-Population Ratio for Women
A growing share of American women are employed



Source: Department of Labor (Bureau of Labor Statistics).

Blacks and Hispanics also experienced rapid growth in employment since 1975 (Chart 3-2). Indeed, employment-to-population ratios for both these groups rose by more (7.4 and 8.0 percentage points, respectively) than did the ratio for whites (6.3 percentage points). By 2000 the ratios for Hispanics and whites were almost equal. Unfortunately, although employment grew faster during this period among blacks than among Hispanics or whites, the black employment-to-population ratio remains lower than for whites, having started from a much lower level. (Comparisons of employment by race and ethnicity are somewhat clouded because the categories of Hispanic, black, and white are not mutually exclusive: some Hispanics identify themselves as white and others as black. Available data do not allow a comparison of non-Hispanic whites and non-Hispanic blacks with Hispanics.)

The growth in employment in the 1980s and 1990s opened the door to increased economic well-being for many more Americans. Workers with a great deal of education and skill benefit from the greater availability of jobs, but so do workers with less education and fewer skills: one study indicates that, at both low and moderate skill levels, more labor market experience means higher earnings; even entry-level jobs provide real economic opportunities. For both lower skill and higher skill workers, real wages grow roughly 5.5 percent a year during the worker's first 10 years in the labor market.

Chart 3-2 **Employment-to-Population Ratio by Race and Ethnicity**

From December 1975 to December 2002 employment-to-population ratios increased 6.3 percentage points for whites, 7.4 points for blacks, and 8.0 points for Hispanics.

Source: Department of Labor (Bureau of Labor Statistics).

Why does time spent in employment, even in low-skilled jobs, promote wage growth? One reason is that labor market experience fosters skill development. In a modern economy, school is not the only place where skills are learned: family members and employers play a central role alongside formal education in developing skills. One study estimates that job mobility, workplace education, and on-the-job learning account for as much as half of all skill formation.

In the dynamic view of labor markets, job changes are not necessarily events to be minimized at all costs, but rather are often changes for the better; for example, job changes can lead to a better matching of workers to jobs. Job mobility also contributes to skill development and wage growth. Young workers change jobs often: a study shows that the typical young worker holds seven jobs over his or her first 10 years of labor market experience, and one-third of the wage growth that young workers experience occurs when they change one job for another. Indeed, two-thirds of lifetime wage growth occurs within the first 10 years of labor market experience. Together this evidence indicates that this job search and job tryout process—playing the labor market field—is a crucial component in the economic progress of young workers.

Job mobility is not limited to the young, of course. Studies show that one-third of new full-time jobs end within 6 months, and one-half to two-thirds end within 2 years. Not surprisingly, then, a large fraction of the work force—roughly one-fifth—have been at their current job for less than a year. However, once a worker has found a good match—a job in which the worker's skills are valued by the employer and the worker is sufficiently compensated, both monetarily and in nonmonetary benefits and amenities—the job often turns into a long-term employment relationship, to the benefit of both worker and employer. Recent studies indicate that such relationships remain common (Box 3-1). The pattern seems to be that many workers switch jobs several times until they find the right one, ratcheting up their wages along the way.

Job mobility and labor market experience, especially for young workers, are an important component of overall income mobility in the United States. In fact, studies of overall income mobility that include the benefits of job mobility and experience find much more mobility than do studies that implicitly exclude these sources of income growth. Box 3-2 provides a further description of these two contrasting ways of looking at income mobility.

Nonwage benefits are also an important indicator of workers' well-being. For the majority of households, health insurance coverage is linked to employment. But even many households with working members lack health insurance. Data from the Current Population Survey, conducted by the Bureau of the Census and the Bureau of Labor Statistics, show that out of a

Box 3-1. Has There Been a Decline in Long-Term Employment?

The fraction of the work force in long-term employment relationships has been falling over time. In 1979 over 40 percent of the work force were in employment relationships that had lasted over 10 years, and over 25 percent had been in employment relationships that had lasted at least 20 years. In contrast, a 1997 study found that only about 35 percent of employment relationships had lasted at least 10 years, and about 20 percent had lasted more than 20 years. However, this decline in the fraction of long-term jobs is largely the result of the rapid expansion in employment that has occurred since 1980 rather than a decline in the number of long-term relationships. Workers who are new to the labor force have short job tenure by definition. There has been no increase in the incidence of job loss among workers with long-term employment relationships.

U.S. population of almost 285 million, 41.2 million lacked health insurance at any given time during 2001. However, just as the unemployment numbers fail to capture the dynamics of the labor market, so, too, these commonly cited estimates of the population without health insurance fail to tell the whole story. The Census figure probably overestimates the number of people who go without insurance for a full year. Data from the Medical Expenditure Panel Survey (MEPS), conducted by the Agency for Healthcare Research and Quality, show that 23.5 million people were uninsured throughout a recent 2-year period, and that 80.2 million were without insurance at some time during that period. For those who lose coverage, the median spell without insurance is 5 months.

In the extreme, the combination of a high rate of workers changing jobs, short durations of many employment relationships, and short average durations of unemployment could reflect either of two possible scenarios. One is that a large fraction of workers are experiencing frequent but temporary layoffs and recalls, such that a re-sorting of workers is taking place among an unchanging set of existing jobs. The other is that workers are fluidly pursuing job opportunities that are continually being created to replace other jobs that are continually being destroyed. Both scenarios are likely at work, but studies show that a substantial amount—35 to 45 percent—of worker turnover is driven by the destruction and creation of jobs. Each year roughly 10 percent of all existing jobs are destroyed, and a roughly equal number of new jobs take their place.

Data from the Bureau of Labor Statistics' Job Openings and Labor Turnover Survey (JOLTS) document that the common notion of a static labor market does not fit the facts even during periods of slow employment growth. The JOLTS gathers data on job openings and job turnovers from a nationally representative sample of roughly 16,000 business establishments. Those data reveal that, in October 2002, there were 3.2 million job openings—that is, available but unfilled positions—the equivalent of 2.5 percent of total employment of roughly 131 million. Moreover, in that same month 4.1 million workers—3.1 percent of total employment—were hired into new positions (from other positions or from nonemployment), and a nearly equal number quit or lost their jobs. The majority of these separations were not layoffs, however; 2.2 million of those 4.1 million workers left their jobs voluntarily. Thus, although nonfarm payrolls increased by only 69,000 between September and October, and unemployment increased slightly (from 5.6 percent to 5.7 percent), there was a large amount of movement both into and out of jobs.

What kinds of policies work best to support workers in need of assistance while maintaining the dynamism of a constantly changing labor market? The Earned Income Tax Credit (EITC) is an example of a policy that works

Box 3-2. Two Ways to Look at Income Mobility

Some studies find substantial income mobility among Americans, whereas others find much less. The differences between these studies depend in large part on whether the income mobility that comes with increased labor market experience is included in the analysis. Studies that include all sources of income mobility are sometimes referred to as "absolute" measures of mobility, whereas those that compare incomes over time of cohorts of individuals of the same age and approximately the same level of experience are sometimes called "relative" measures of mobility.

Studies of absolute mobility find that 80 percent of individuals in the bottom quintile of the income distribution were in a different quintile 10 years later. This finding suggests that most people at the bottom of the income distribution move up as they gain labor market experience. Even studies that examine the absolute mobility of men in their prime working years (ages 25 to 44), after many job changes and after much wage growth has already occurred, find a substantial amount of mobility.

Studies of relative mobility find less movement out of the bottom quintile: only about half of workers in that group are no longer there after 10 years. These studies show that much of an individual's upward mobility is shared among all members of the cohort. Changes in the relative ranking of incomes among members of a cohort are a good measure of social mobility, whereas changes in the absolute level of incomes are a good measure of mobility in economic well-being. Taken together, these studies show a substantial amount of both concepts of mobility.

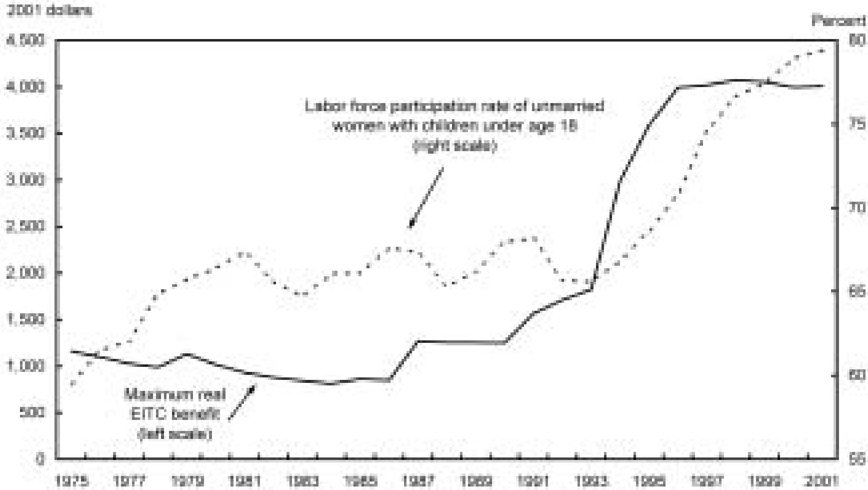
because it encourages rather than discourages mobility in the labor market (Box 3-3). It does so because its implicit subsidy to earnings, which can be as large as 40 percent, increases the rewards associated with work for the low-income individuals to whom it is targeted. The credit thus provides an incentive for those without jobs (including those on public assistance) to enter or reenter the labor force. Indeed, several studies have found that the EITC increases labor force participation among those eligible. The effect is particularly strong for single parents. One study found that, between 1984 and 1996, the EITC accounted for roughly two-thirds of the 4.7-percentage-point rise in labor force participation among single mothers with children. By 2001 the labor force participation rate of these women had risen an additional 8.6 percentage points (Chart 3-3). In addition, studies have found the EITC to be more than twice as effective as the minimum wage at lifting families with children out of poverty, partly because of the program's positive employment incentives.

Box 3-3. The Earned Income Tax Credit

The EITC is a tax credit for the working poor. Benefits are paid only to those who work, and these benefits rise as earnings increase. Because the tax credit is refundable (that is, it can exceed the amount of income tax otherwise due), families who pay little or no income tax can benefit fully from the program.

The program works as follows. Families are eligible for the credit if a member of the family works. The benefit amount depends on the family's labor market earnings, the number of children in the family, and the marital status of the tax filer. In 2003 a family with two or more children receives a subsidy of 40 cents for each dollar of earned income up to $10,510. From that level the credit remains stable at $4,204 until earnings reach $13,730 ($14,730 for a married couple). Single individuals and families without children are also eligible but typically receive less. The credit phases out over a range of income from $13,730 through $33,692 ($14,730 to $34,692 for a married couple). Over this range there is a relatively high implicit marginal tax rate on earnings. For example, for each dollar earned between $13,730 and $33,692, a family with two or more children sees its EITC benefit reduced by roughly 21 cents (Chart 3-4). According to the latest estimate from the Bureau of the Census, the EITC lifted 3.7 million people out of poverty in 2001.

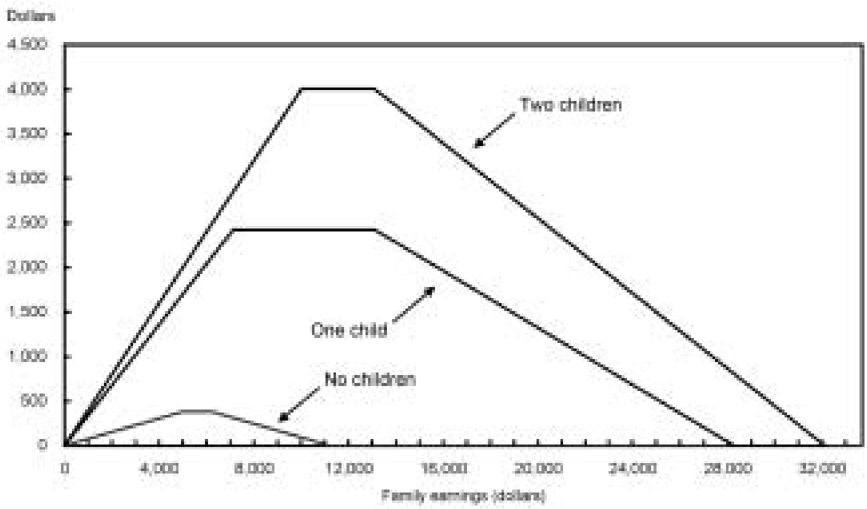
Chart 3-3 **EITC Benefit and Labor Force Participation of Unmarried Women with Children**
The rise in the labor force participation rate of unmarried mothers began shortly following the increases in the maximum EITC benefit and has continued since.



Note: Maximum EITC benefit is that for a family with two or more eligible children. Real benefit is computed by deflating cash benefits using the CPI-U-RS.

Sources: Department of Labor (Bureau of Labor Statistics) and the Congress (Joint Committee on Taxation).

Chart 3-4 **EITC Benefit by Family Earnings and Number of Children for 2003**
The benefit received by working families first increases and then decreases as the family earns more.



Note: Benefit levels are for all households except for married, joint filers. Under EGTRRA, the earnings level at which the benefit phaseout begins for married, joint filers is $1,000 higher than for all other filers.

Source: Department of the Treasury (Internal Revenue Service).

Unfortunately, the EITC can also provide an earnings disincentive for some low-income families who are already working. This disincentive comes about because, over the income range in which the EITC is phased out, recipients face a relatively high implicit marginal tax rate on earnings as the subsidy is withdrawn. For example, for families with two or more children, each additional dollar earned between $13,730 and $33,692 of income reduces the credit by roughly 21 cents. In effect, this places an additional 21 percent tax on these families' work efforts over that range of income. Of course, if the phaseout were steeper and the implicit marginal tax rate higher, fewer families would be affected by the disincentive. A further concern is that a substantial amount of noncompliance or error occurs within the program. The Internal Revenue Service has estimated that, of the roughly $31.3 billion in EITC claims filed in 2000 for tax year 1999, between $8.5 billion and $9.9 billion (27.0 to 31.7 percent) was improperly claimed and should have been disallowed. This raises questions as to whether the resources devoted to the EITC are being targeted in the most effective and efficient way possible.

In stark contrast to the EITC, which recognizes the dynamics of labor market mobility and fosters labor force participation, the quintessential static labor market policy is the minimum wage, or the closely related variant known as the "living wage." Policies such as these, which mandate that employers pay their workers higher wages than they might pay voluntarily, could be justified by the view that most labor market entrants will be stuck in low-wage jobs and will not experience substantial wage growth over their careers. Both the minimum wage and the EITC increase the earnings of those low-income individuals who work. But whereas the EITC increases employment, the minimum wage likely reduces it: the most recent studies have found that significant employment losses are associated with minimum wage policies.

What accounts for this difference in effects on employment? The EITC effectively lowers the wage at which potential low-income workers are willing to work but does not affect the demand of employers for their labor services. A minimum wage, on the other hand, increases the cost to an employer of hiring a low-wage worker and consequently reduces that employer's demand for labor services. Even when the minimum wage does not lead firms to reduce employment, it has been found to reduce the amount of employer-based training young workers receive. Another reason why the EITC is a more effective policy is that it is targeted to those workers who need it most: workers, especially workers with children, from low-income families. The minimum wage, on the other hand, applies to all workers whose wages would otherwise be below the minimum; this includes low-wage workers from families whose other working members earn high wages.

Unemployment Assistance Policy

As noted at the outset, 6.0 percent of the labor force were unemployed in December 2002; many more Americans face the risk of becoming unemployed. On December 14, 2002, the President called on the Congress to extend unemployment benefits for the 750,000 unemployed workers whose benefits would have otherwise expired. He further asked that this benefit extension be retroactive, so that no one who is unemployed would fail to receive any portion of benefits to which he or she is entitled. The Congress responded to the President's call, and on January 8, 2003, the President signed this extension into law.

Unemployment and the risk of unemployment are a reality in a flexible labor market like that of the United States. But this same flexibility also results in higher overall employment than would prevail in an inflexible, static labor market. Recognizing the job uncertainty inherent in a dynamic, flexible labor market, government has long undertaken to provide social insurance against the risk of lower income resulting from job loss. However, the government's unemployment policies should always take into account the substantial and continual movement of workers into and between jobs and into and out of unemployment.

The Federal-State Unemployment Insurance (UI) program provides unemployment benefits to eligible workers who are unemployed through no fault of their own (with fault being determined under each State's law) and who meet other eligibility requirements set by each State individually. Workers who are unemployed because they are new labor market entrants, have recently reentered the labor market, have quit a job, or were fired for cause are not eligible for UI benefits. Although the formula used to determine benefits varies from State to State, the dollar amount always depends on the worker's previous earnings up to a specified maximum. There is also a minimum UI benefit for workers with especially low earnings. Because of this truncated benefit structure, the UI replacement rate (the ratio of the benefit to the recipient's previous earnings) is higher for low-paid than for high-paid workers, making UI relatively more attractive to those who earned low wages while working. In most States workers can receive up to 26 weeks of UI benefits; States with unusually high unemployment may offer an additional 13 weeks of extended UI benefits.

Statistics on the duration of unemployment show that although most unemployment spells are short, their average duration is longer in the period immediately following a recession. (These statistics cover all unemployed workers, not just those receiving UI benefits.) On average over all recessions and expansions since 1970, the median duration of unemployment has been 8.2 weeks in the year following a recession and 6.6 weeks at other times.

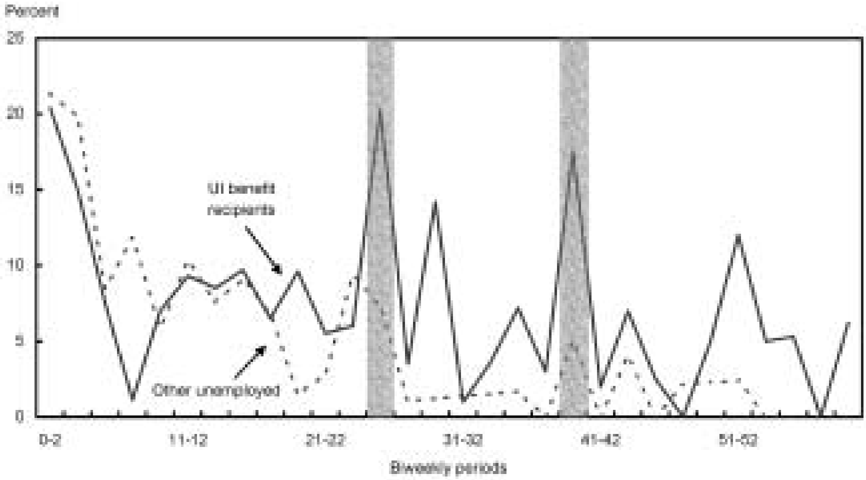
Similarly, 38.2 percent of unemployment spells are of 5 weeks or less immediately after a recession, compared with 44.0 percent at other times. However, the surveys used to generate most labor market statistics may overstate the duration of the typical unemployment spell. In one study that examined completed spells of UI recipients after the unemployed worker had found another job, it was estimated that 35 percent had returned to work within 4 weeks of their job loss.

The most recent recession has followed the pattern of previous recessions: the median duration of unemployment spells rose from 6.4 weeks in March 2001 to 9.6 weeks in December 2002. In March 2002 the President responded to this need by signing the Job Creation and Worker Assistance Act (JCWAA), which provided an additional 13 weeks of temporary extended unemployment benefits to all eligible unemployed workers, and in January 2003, as noted above, the President again extended unemployment benefits.

Any time that policymakers consider offering or extending UI benefits, they face a difficult tradeoff. UI can provide valuable assistance to unemployed workers, but it may also create a disincentive for benefit recipients to return to work. Unemployed workers who rationally evaluate their options may postpone accepting new work until their UI benefits are exhausted or nearly exhausted. The result is higher unemployment and longer average spells of unemployment. In the study cited above, for example, 40 percent of those who had not received UI benefits, but only 35 percent of those who had, returned to employment within 4 weeks of their job loss. This 5-percentage-point difference hints at the disincentives built into UI, since fewer of those receiving it returned to employment quickly. Another study found more direct evidence: each additional week of UI benefits was estimated to increase the duration of the average unemployment spell by about a day. Many other studies have also found an association between the level of weekly UI benefits and the duration of unemployment. Still more evidence comes from Europe, where most countries have more expansive UI policies than the United States and have higher rates of unemployment and longer average unemployment spells. Although these differences in unemployment outcomes may not be due to differences in UI policies alone, the totality of the evidence suggests that they contribute.

Chart 3-5 illustrates another aspect of the relationship between the availability of UI benefits and incentives to find a new job. Unemployed workers who receive UI benefits are more than twice as likely to find a job in the week before their regular benefits expire than in the several weeks immediately preceding. As noted above, UI benefits expire after 26 weeks unless extended, in which case they expire at 39 weeks (for workers receiving either extended UI benefits or temporary extended UI benefits). Perhaps not coincidentally, peaks in the fraction of unemployed workers finding work also

Chart 3-5 **Fraction of Unemployed Workers Finding Work by Number of Weeks Unemployed**
Unemployed workers receiving UI benefits are more likely to find work when benefits are about to expire.



Note: Shaded areas represent periods when UI benefits expire: regular UI (26 weeks); extended UI or temporary UI (39 weeks).

Source: Lawrence F. Katz and Bruce D. Meyer, "The Impact of the Potential Duration of Unemployment Benefits on the Duration of Unemployment," Working Paper No. 241, Industrial Relations Section, Princeton University, 1988.

occur around these expiration dates. Among unemployed workers who do not receive benefits, in contrast, there is no substantial difference in the likelihood of finding a job at these points in their unemployment spell.

Moreover, although in theory workers should benefit from the longer time that UI allows them to search for a new job, evidence of such a benefit is hard to come by. Some States have experimented with giving UI recipients a cash bonus if they start a new job before exhausting their benefits. These reemployment bonuses have been found to reduce the number of weeks of UI receipt, as was hoped. But researchers also found that those unemployed workers who received bonuses—and consequently returned to work sooner—did not, on average, end up taking lower paying jobs upon reemployment than those who did not receive bonuses. These findings suggest that the longer period of time that traditional UI recipients remain unemployed does not necessarily lead them to find jobs better matched to their skills. One possible downside to the reemployment bonuses is that the prospect of the bonus may induce more unemployed workers to claim UI in the first place, especially if they believe they will find work quickly and therefore might not bother to claim UI were it not for the bonus.

The President's Personal Reemployment Accounts proposal, announced on January 7, 2003, builds on the demonstrated potential of reemployment bonuses to speed unemployed workers' reentry into the work force. The proposed accounts would also add flexibility to the provision of training for unemployed workers while avoiding penalizing those who quickly return to work. Under the proposal, qualifying unemployed workers would each be given an account with a value of $3,000, which the recipient could use for reemployment services, training, or supportive services such as transportation or child care. Recipients who become reemployed within 13 weeks of receiving their first UI payment would be able to retain any balance remaining in the account as a cash reemployment bonus. Those who do not find work within that period would not be able to cash out their account but could continue to use it for services while receiving UI benefits.

The President has proposed that States be granted a total of $3.6 billion to create the new accounts, enough to provide immediate assistance for up to 1.2 million unemployed workers. The accounts would be targeted at those unemployed workers who are very likely to exhaust unemployment benefits before finding a new job. In some circumstances, States would be able to provide the accounts to those unemployed workers who have already exhausted their UI benefits within the last 3 months.

The flexibility that the new accounts would provide in accessing unemployment services and benefits is important, because research has shown that the economic impact of unemployment differs greatly from worker to worker, reflecting differences in their underlying skills and in their circumstances. For those unemployed workers whose skills are no longer valued in the marketplace, extensive retraining may be appropriate. Other unemployed workers may need help relocating or weathering a spell of unemployment but have marketable skills and require little or no retraining. The President's proposal recognizes that the people best suited to evaluate their current skills and match them with market opportunities are the displaced workers themselves.

Personal Reemployment Accounts are not intended as a replacement for UI but rather would be structured as a new component of the UI system. They would be offered as an additional option to those UI recipients who, under current UI rules, are referred to reemployment services. Eligibility for an account would be a one-time event.

Who would be eligible to receive Personal Reemployment Accounts? In October 2002 there were 8.2 million unemployed workers, and in that same month roughly 700,000 workers received first payments from the UI system. Current law requires that States identify those UI applicants who are likely to exhaust their benefits and refer these individuals to reemployment services. Although each State applies different criteria, the factors used to identify these workers include local unemployment rates, level of education, recent job tenure, and prior employment in an industry or occupation in decline or particularly hard hit by economic downturn. From July 2001 through June 2002, 10.4 million individuals began to receive UI benefits, and 1.2 million, or about 12 percent, were judged to be very likely to exhaust 26 weeks' worth of regular UI benefits and were referred to reemployment services. Personal Reemployment Accounts are targeted to those workers.

In more specific terms, Personal Reemployment Accounts would work in the following way. UI recipients identified by their State as being very likely to exhaust UI benefits under current law already must register with the State's Workforce Investment Act program to become clients of the already-established network of one-stop career centers. These recipients would be given the option of receiving in addition a Personal Reemployment Account as part of the intensive services they receive. The career centers would administer the accounts on the recipients' behalf. The worker would continue to be eligible for and receive UI benefits and would be free to use the core services provided by the one-stop career center. Personal Reemployment Accounts thus represent additional dollars available to the unemployed recipient.

Funds from the accounts could be used for other training and support services (such as transportation and child care) at the recipient's discretion. The career center would use an "advanceable" process such as smart cards or an allowable billing process to permit recipients to make payouts from the account.

If the recipient is reemployed within 13 weeks of starting UI benefits, the career center would pay him or her, in cash, any balance remaining in the account. The account would then be closed. States would have the option of providing the cash balance as a single lump sum or in two installments of 60 percent and 40 percent, the latter after the recipient has been on the new job for 6 months. The one-stop career center would distribute these bonus payouts according to the policy of the State in which it is located. After the cash payout is completed, the recipient could continue to use all of the no-cost automated and staff-assisted basic reemployment services available at the career centers. He or she would not, however, be eligible for intensive services such as counseling, case management, or training under the Workforce Investment Act for a period of 1 year after the cash payout. Recipients who do not find employment within 13 weeks of starting UI benefits would be able to continue to use the resources in the account for intensive, training, or supportive services.

The potential to receive a reemployment bonus would provide eligible workers a greater incentive to find new employment. At various times from 1984 to 1989, four States—Illinois, New Jersey, Pennsylvania, and Washington—conducted controlled social experiments to determine the effectiveness of providing reemployment bonuses to unemployed workers. In these experiments, a random sample of new UI claimants were told they would receive a cash bonus if they became reemployed quickly. The advantage of these experiments is that the effect of offering a reemployment bonus on the duration of unemployment and on earnings upon reemployment can be directly evaluated by comparing the experiences of UI claimants randomly chosen to be offered a reemployment bonus with those of UI claimants not chosen for the bonus (who received the regular State UI benefit).

An evaluation by the Department of Labor of the reemployment bonus experiments conducted in the States of Washington, New Jersey, and Pennsylvania showed that a bonus of $300 to $1,000 motivated the recipients to become reemployed, reduced the duration of UI by almost a week, and resulted in new jobs that were comparable in earnings to those obtained by workers who were not eligible for the bonus and remained unemployed longer. Similarly, a study of the experiment conducted in Illinois found that a reemployment bonus of $500 reduced the duration of unemployment by more than a week and did not lead to lower earnings at the worker's next job. Therefore it is likely that giving unemployed workers the option of receiving the unspent balance in their Personal Reemployment Accounts will provide them an incentive to find a new job quickly, reducing the time spent unemployed, but will not result in workers taking lower paying jobs than they would get if they searched longer.

A potential problem with Personal Reemployment Accounts is that, like other reemployment bonuses, they may make UI benefits more attractive for unemployed workers who expect to find new employment quickly and thus would be unlikely to apply for traditional benefits. However, the fact that Personal Reemployment Accounts would be targeted to those workers whose characteristics are highly correlated with long-term unemployment makes it much less likely that the accounts would induce entry into the UI system.

Workers adversely affected by international trade are eligible for support from another Federal program separate from the UI program: the Trade Adjustment Assistance program. To further assist these dislocated workers, the President and the Congress extended benefits under the program as part of the Trade Adjustment Assistance Reform Act of 2002. The main features of this part of the legislation include an extension of eligibility and an expansion of benefits. To be eligible for these benefits, laid-off workers must have been working in an industry in which either sales or output has declined, and increased imports must have contributed importantly to their being laid off. (Workers subjected to partial rather than full layoff are also eligible.) Benefits include both cash and training benefits, a tax credit for health care expenses, and eligibility to participate in State-run high-risk insurance pools and other State-based efforts to extend health care coverage. A pilot program for wage insurance has also been launched for these workers. The program offers a wage subsidy for eligible workers over 50 who take a new job at a lower salary. The subsidy pays half of the difference in wages between the old and the new job, up to $10,000. This program is particularly noteworthy because it provides a direct incentive for seeking reemployment quickly.

Dynamics of Program Participation and Social Policy

Government social support is, of course, not limited to the unemployed. Disability and spells of low income resulting from any cause are additional risks against which the government may have a role in providing social insurance. In 2002 approximately 2 million families received TANF cash assistance in any given month; another 5.2 million individuals received Supplemental Security Income (SSI) payments, 6.9 million received Social Security Disability Insurance (SSDI) payments, and some received both.

Most spells of welfare benefit receipt are of short duration: studies of AFDC typically show that half of such spells ended within 1 or 2 years. However, a significant fraction of welfare spells last a long time. In a study conducted before the passage of welfare reform in 1996, 18 percent of spellswere found to last 5 years or longer, and one-quarter of recipients had spent 10 years or more on welfare, although not necessarily all in one spell. Since 1996, substantial progress has been made: welfare caseloads have fallen by 54 percent, and is it likely, although no studies are yet available, that the duration of welfare spells has shortened as well.

SSDI provides benefits to disabled and blind individuals who are insured through workers' payroll tax contributions. The worker must have worked and paid Social Security taxes for a sufficient number of years and must have worked recently to qualify for benefits. SSI, in contrast, is a means-tested program for persons who are 65 or older, or of any age if the recipient is blind or disabled. (A means-tested program is one in which eligibility is determined by income or some other measure of the applicant's means of self-support, as opposed, for example, to a record of past contributions to an insurance fund.) SSI is a program of last resort; its benefit formula takes into account income received from other sources (including other Federal, State, and local programs as well as private efforts). It does not duplicate these sources but rather fills the gap between them and a specified minimum level of income. Both SSDI and SSI define adult disability as the inability to engage in any substantial gainful activity because of a mental or physical impairment that is expected to result in death or that lasts for a continuous period of at least 12 months. As of 2002 "substantial gainful activity" was defined as work paying over $780 a month, when the impairment is other than blindness, and over $1,300 a month for blindness. The average monthly SSDI benefit in 2002 was $817, and the maximum monthly SSI benefit was $545.

In contrast to TANF, participation in the SSDI and SSI programs has not decreased in recent years (Box 3-4). Of course, unlike with TANF, individuals

Box 3-4. The Growth in SSDI and SSI Disability Caseloads

The number of people receiving disability payments through either the SSDI or the SSI program has increased dramatically. From 1990 to 2002, the number of SSDI recipients rose by 3.0 million, and from 1990 to 2001 the number of SSI recipients rose by 2.1 million. The President supports a program that would address this rise in disability caseloads by helping people with disabilities reenter the work force.

In 1999 Congress passed the Ticket-to-Work and Work Incentives Improvement Act, which addresses the disincentives to return to work that many individuals with disabilities face. The act allows recipients of SSDI and SSI to choose their own vocational rehabilitation and support systems, and it extends the Medicare benefits of SSDI recipients so that they do not lose health benefits on returning to work. The act also expands Medicaid eligibility for persons with severe disabilities. The President has promised swift implementation of this initiative, to be completed by the end of 2003.

apply to receive disability payments both because they require income support and because health impairment limits their ability to work and perhaps increases their demand for medical services. Thus one would expect a lower rate of exit from SSDI and SSI than from TANF, even if their incentive structures were identical. Indeed, a low rate of exit has been the norm for these programs: each year only about 1 percent of those who receive SSDI or SSI leave the rolls to go to work.

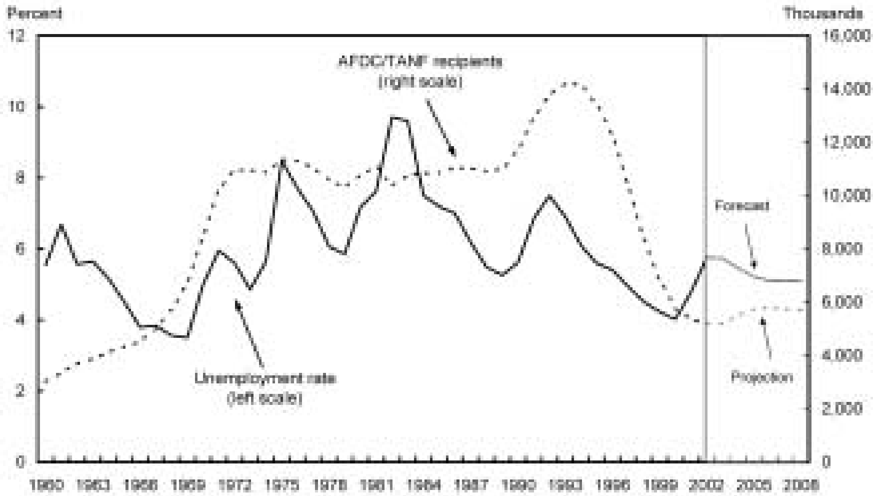
How should welfare programs be designed for a dynamic labor market? If labor markets were static, the design of social insurance to provide welfare, like the design of UI, would be straightforward: the government would simply provide cash assistance to needy families. In a dynamic labor market, however, needy families typically require welfare benefits only for brief spells. This very dynamism makes the design of welfare programs more difficult, because policymakers again face a tradeoff. Welfare programs that provide cash benefits without work requirements or time limits, such as the former AFDC program, provide eligible families with needed assistance, but they also create a disincentive for the adult members of those families to acquire skills, to enter or reenter the work force, and to escape poverty. (They also create a modest incentive to remain unmarried and to have children out of wedlock, because the presence of a working husband reduces the benefit whereas that of an additional child increases it.) The work disincentives that were part of AFDC (which in part remain under TANF) arose because benefits were phased out as family income increased, imposing a high implicit marginal tax rate on income earned by families receiving AFDC. Although any well-designed means-tested public assistance program would include an income phaseout and thus face this problem of high marginal "tax" rates, the AFDC program unintentionally promoted dependency on welfare and induced some families to have longer spells of welfare receipt.

The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 was motivated by the recognition that a better policy for families requiring welfare assistance was needed. The reform granted greater program authority to State governments and replaced the AFDC program, which was based on Federal provision of matching funds to the States, with TANF, which is a block grant program. These reforms essentially abolished Federal eligibility and payment rules, giving States much greater discretion in designing their own cash public assistance programs, and eliminated the Federal entitlement to cash assistance. TANF not only gave States the freedom to set their own eligibility criteria and benefit levels but also created work requirements for recipients, set a lifetime limit of 60 months of TANF assistance, and rewarded States for strong performance in terms of reduced caseloads.

As noted previously, caseloads have fallen by 54 percent since PRWORA's enactment. However, because the unemployment rate was falling during much of this period, an important question is whether the decline in caseloads was due to welfare reform itself or to the strength of the labor market. A number of studies based on experiences during the period of extensive State experimentation with welfare program waivers have found that economic growth and the consequent decline in unemployment rates likely had a secondary role in the decline in caseloads. As Chart 3-6 shows, the correlation between unemployment and the number of AFDC/TANF recipients that is evident in the 1990s, and particularly after welfare reform, was not evident in earlier periods of declining unemployment rates.

The era of innovation in welfare policy began with the granting of AFDC waivers in the late 1980s: certain restrictions under the AFDC program were waived for States wishing to experiment with alternative welfare program designs. PRWORA continued this process, with the result that the particulars of State programs now vary widely. One important dimension on which they differ is the rate at which welfare benefits are reduced as the recipient's income rises. This benefit reduction rate had been set by Federal law under AFDC. Under PRWORA, many States have chosen a lower implicit rate in an effort to increase the incentive to work and to provide more assistance to low-wage workers. Lower benefit reduction rates, in conjunction with increased work mandates, time limits, and work support programs, do appear to have increased work incentives. By 2000, States reported that, in

Chart 3-6 Unemployment and AFDC/TANF Recipients, 1960-2008
The number of welfare recipients and the unemployment rate did not move in tandem until the late 1980s. A projection based on their relationship and on an unemployment forecast suggests that the number of TANF recipients will increase only slightly.



Sources: Department of Health and Human Services (Agency for Children and Families), Department of Labor (Bureau of Labor Statistics), and Administration Forecast, February 2003.

the aggregate, 34.0 percent of the welfare caseload were engaged in work or job-related activities, up from 20.4 percent in 1994. Although States remain subject to a Federal 60-month maximum time limit for individuals receiving TANF funds, they can set shorter time limits or use State funds to extend benefits. PRWORA has also increased expenditure on work support programs such as subsidies for child care; between 1993 and 2000 annual Federal child care subsidies almost doubled, from $9.5 billion to $18 billion.

With the recent economic slowdown and continued weakness in job growth, a critical question is whether the number of TANF recipients will increase to their pre-1996 levels. Analysis based on the relationship between unemployment rates and recipients, combined with current forecasts for unemployment in 2003 and beyond, suggests that the number of recipients will increase only slightly and will not approach prereform levels (Chart 3-6).

Although it is still too soon to reach a final conclusion, welfare reform—both TANF and the innovative policies implemented by States before and since the enactment of PRWORA—seems to have had a remarkable impact on public assistance caseloads. The reductions in caseloads, moreover, have not been concentrated geographically but have been seen across the Nation.

PRWORA has also shown positive, although still preliminary, effects on employment, earnings, marriage rates, and the prevalence of single female-headed families.

At the same time that caseloads began to fall, employment increased dramatically among the population most affected by the caseload declines. Among those who reported receiving public assistance income in the previous year, the share reporting being employed in March of the following year rose from 19.8 percent in 1990 to 44.3 percent in 2000. Even among those who remained on welfare, work effort greatly increased, possibly reflecting both the work requirements and the rates at which benefits were reduced with income. Among women on welfare, those who reported labor earnings rose from 6.7 percent in 1990 to 28.1 percent in 1999. The research literature suggests that approximately two-thirds of welfare leavers are employed at any future point in time. In addition, employers have often rated welfare recipients as performing as well as or better than other employees. One study finds that former welfare recipients have higher rates of wage growth than do other workers.

Poverty and income levels are directly tied to employment and wages. Studies suggest that, just as it has raised employment, welfare reform has also reduced poverty and increased income. For example, poverty among all families headed by a single mother declined from 35.4 percent in 1992 to 26.4 percent in 2001. This finding is consistent with research showing that States that adopted innovative welfare programs under AFDC waivers before 1996 recorded an average 2.4-percentage-point decline in the poverty rate of the entire population of less skilled women. PRWORA itself was associated with a 2.0- to 2.2-percentage-point decline in the poverty rate.

Research shows that, although many lost government assistance, single mothers saw their incomes increase on average during the 1990s. Studies of those who have left welfare reveal that around half remain in poverty, but evidence also points to increases in family income over time. Data on consumer expenditure meanwhile reveal increases in spending by low-income single mothers in the 1990s.

Why has welfare reform been so successful? Studies of the States' experiments with work requirements under AFDC waivers suggest that these requirements led to increases in employment and reductions in welfare payments. The effect of time limits is less well established, because few recipients have yet exhausted their eligibility under PRWORA, and evidence from those States that implemented time limits as part of their AFDC waiver programs is mixed.

Fostering Skill Development

Labor market experience fosters the development of valuable skills. As noted earlier, in addition to formal educational institutions, family members and firms play a central role in skill development in the modern economy. Job mobility, workplace education, and on-the-job learning by doing account for as much as 50 percent of all skill formation. Training on the job, together with simply the experience of being in the labor market, has been found to be more effective at increasing the earnings of young workers than are government training programs. Indeed, evidence from evaluations of formal, publicly provided job training programs for youth demonstrates that they have little or no impact on earnings.

When younger workers change jobs, the switch is usually accompanied by an increase in wages, possibly because they have both increased their skills and moved to jobs that use those accumulated skills more effectively. In contrast, job changes for more experienced workers often result from job loss and may result in lower earnings. Experienced workers who lose their jobs at a given time are more than three times as likely to experience one or more additional spells of unemployment in the following 2 years than similar workers who did not lose their jobs at that time. In addition, more than one-quarter of experienced workers who lose their jobs suffer substantial wage reductions when they do return to work. The reductions in employment are short-lived: within 4 years of the job loss, workers who lost their jobs have a virtually identical likelihood of being employed as workers who did not lose their jobs. But the wage losses are long lasting: 4 years after a job loss, the average weekly earnings of job losers are 10 to 13 percent below those of workers who did not lose their jobs. These permanent declines in wages likely reflect a deterioration in the value of the skills these older workers had previously acquired. This makes fostering the reacquisition of skills among experienced workers who have lost their jobs a policy priority.

Some types of worker retraining have been effective at increasing the earnings of displaced workers. One evaluation of a training program that subsidized community college attendance by displaced workers found that 1 academic year of community college raised these workers' earnings by about 5 percent.

Technically oriented vocational skills and science and math skills are particularly important for displaced workers, because investments in these skills result in much higher returns in the labor market than does non-technically oriented training. One study found that the expected return on earnings from a curriculum that provides an academic year of more technical and applied coursework ranges from 10 to 15 percent.

The labor market rewards skill accumulation and investment in human capital. In particular, it rewards with higher wages those who obtain more schooling. Studies estimate that each additional year of education increases a worker's wages by 6 to 10 percent on average. The Bureau of Labor Statistics reports that, in the fourth quarter of 2002, bachelor's degree holders over the age of 25 had an unemployment rate of 3.0 percent, and those working full-time earned a median weekly income of $944, whereas workers with only a high school degree earned a median weekly income of $545 and had an unemployment rate of 5.1 percent. Americans have responded to the benefits of human capital investment: in 1959 only 2 in 10 jobholders had some college education; today roughly 6 in 10 are college educated.

The benefits of education not only are large but have increased. The difference between the average earnings of college-educated workers and those of high school-educated workers has increased by almost 70 percent since the early 1980s. Education may also generate gains for society at large: it is correlated with better public health, better parenting, lower crime, a better environment, wider political and community participation, and greater social cohesion, all of which may contribute to economic growth.

Earnings increase with age, with increased tenure on a job, and with the accumulation of both general and job-specific human capital. Between 1963 and 1989, men with 30 years of job experience earned 75 to 85 percent more, on average, than men in their first 5 years out of school. Furthermore, one study finds that the past three decades have witnessed an increase in this premium: whereas in 1969 high school-educated men with 30 years of work experience earned 62 percent more than new entrants with the same education, by 1989 they were earning 110 percent more. In addition, workers who have been at the same job a long time tend to stay there: accumulated tenure is negatively related to turnover rates. The rising importance of experience points to the value of employer-provided training. One study finds that on-the-job training accounts for at least two-thirds of the growth in wages in any given year.

The President, recognizing the individual and economy-wide benefits of an educated society, has vowed to make educating every child in America a top priority. On January 8, 2002, he signed into law the No Child Left Behind Act, designed to improve elementary and secondary education. The act requires stronger accountability and high standards of achievement, to be measured through annual testing of third through eighth graders and publicly released report cards of school performance. It gives students who attend low-performing schools, and their parents, greater scope to seek better options. The act gives State and local governments greater control over Federal education funding, which was increased by 49 percent from its 2000 level, to $22.1 billion in 2002. It creates a highly qualified teacher initiative, supported by investment, research, and training, and it increases Federal money devoted to the teaching of reading. The Administration's commitment to education highlights the importance of investing in the Nation's human capital, benefiting both individuals and the economy as a whole.

Conclusion

Policymakers can help labor markets work better, but they need to remember that labor markets are dynamic, and that the policies that work best for a dynamic labor market are very different from those that work best for a static labor market. Static labor market policies may unintentionally induce workers to accept longer spells of poverty and unemployment and to remain in lower paying jobs. The policies described in this chapter should encourage mobility and help workers smooth over the difficulties they encounter during labor market transitions.